

Internal Revenue Service
memorandum

CC:TL:B12
LMWachtel

date: MAR 6 1987

to: District Counsel, [REDACTED] CC: [REDACTED]

from: Director, Tax Litigation Division CC:TL

subject: [REDACTED] (Tax Years [REDACTED] & [REDACTED])
Pre-90 Day Case
Your ref: CC:MIL-TL-N-502-87

This responds to your request for technical advice on the issues set forth below.

ISSUES

1. Whether the indebtedness created by a contract agreement between [REDACTED] and the [REDACTED] pursuant to [REDACTED] Statute [REDACTED] permitting the formation of "tax incremental districts" creates a municipal obligation for the purpose of § 103 of the Internal Revenue Code of 1954. 0103.02-00.
2. Whether the transfer of real property from [REDACTED] to the [REDACTED] amounts to a condemnation and fails to qualify as a municipal obligation the interest on which is tax-exempt because of the absence of the exercise of municipal borrowing power. 0103.02-00.

CONCLUSIONS

1. Any municipal contract specifying the payment of interest (in the absence of a condemnation proceeding or the threat of one) creates an obligation on which the interest is excludible from gross income.
2. Dedication of real property to a political subdivision is a voluntary act of the owner and is to be differentiated from condemnation for the purposes of §103 of the Internal Revenue Code of 1954.

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FACTS

_____ is a _____ manufacturer of _____, _____, and _____ with plants throughout the United States, Canada, and Mexico. The principal office of the company is located in the _____, _____. The _____ family owns _____ percent of the _____ stock. Another _____ percent is owned by the _____ and the _____. The ownership of the residue is not indicated.

The company has _____ real estate holdings in and around the _____. These include the ownership of all of the undeveloped land within the _____. Accordingly, the company controls the use to be made of this undeveloped land. All of the business and commercial development within the _____ is owned and operated by the company.

The _____ is a planned community first laid out in _____. By the _____s nearly half of the residents were retired and there was very little movement into the community by young and middle aged persons. Without expansion of the tax base inevitably higher taxes would fall on an increasingly retired population.

In the mid-_____s the _____ was commissioned by _____ to draw up a _____-year plan for the community that would guide development of the _____ into the 21st century. This plan would encompass the development of _____ acres of land including major residential, commercial, and recreational development. The plan called for the population to grow from _____ to _____ by the year _____.

In _____ the company presented the plan to the _____ board which approved the zoning changes needed for implementation of the plan. The method of financing the development was apparently not discussed at the meeting.

It is not clear what actions took place during the period between _____ and _____ but the company at least became aware of the existence of the _____ Tax Increment Law. _____. This law provides for the creation of special tax districts for the financing of improvements within the districts. Among other requirements the district must contain at least _____ percent real property meeting the criteria of "blighted", in need of rehabilitation work or conservation or suitable for industrial sites and so zoned.

The company proposed to the _____ that two special tax districts be created to help finance the public improvements for the projects that the company had in mind. One was for residential subdivisions and the other was the _____. The

improvements for the residential subdivisions consisted of installing public utilities, streets, land acquisition for a senior citizens center, a lake, and all qualifying associated costs. The improvements for the [REDACTED] project consisted of installation of public utilities, streets, recreational areas, and other associated qualifying costs. After protracted and acrimonious debate over a period of months between the company and the [REDACTED], the special tax district plan was approved.

On [REDACTED], an agreement entitled "[REDACTED]" was signed by the [REDACTED] and the company. The agreement was later amended twice regarding matters not germane to the issues here. The agreement provided that the tax incremental districts would be created and that the company would contract for the various public improvements and would be reimbursed by the [REDACTED]. It also provided that the liability of the [REDACTED] for repayment for amounts advanced by the company and interest at stated rates would be limited to the amounts of tax increments received by the [REDACTED] in each year on the tax incremental districts. This obligation for reimbursement was expressly made contingent on receipt of tax increments sufficient to pay the amounts due. If at the end of the period for the tax incremental districts ([REDACTED] years) there were amounts remaining due, no further payments to the company by the [REDACTED] would be required. It was estimated that the [REDACTED] had approximately \$[REDACTED] of borrowing authority remaining at the time before it exceeded its constitutional debt limitation.

Under [REDACTED] Statutes [REDACTED] the recording of the plat has the effect of conveying title to parcels dedicated as streets to the municipality. The acceptance of the plat for the tax incremental districts had this effect.

DISCUSSION

Section 103(a) of the Internal Revenue Code of 1954 provides that the interest on the obligations of a state or its political subdivisions is not includible in gross income. The term "political subdivision" includes any division of a state or local governmental unit which is a municipal corporation or which has been delegated the right to exercise part of the sovereign power of the unit. This may include special assessment districts. Treas. Reg. § 1.103-1(b). The principal requirements are that the entity be created by state action and that it have some of the powers of a municipality, such as police power, eminent domain authority, and the power to tax. Rev. Rul. 57-187, 1957-1 C.B. 65.

In order for interest paid by a political subdivision to be tax-exempt, it must be incurred as an obligation under the borrowing power of the entity. See, Stewart v. Commissioner, 714 F.2d 977, 981 (9th Cir. 1981). It is not necessary that the obligation be in any particular form, such as a bond or a note.

The exemption applies to obligations evidenced by ordinary written agreements entered into by duly constituted authorities empowered to enter into such agreements by which the political subdivision agrees to pay interest. Newlin Machinery Corp. v. Commissioner, 28 T.C. 837 (1957), acq. 1958-1 C.B. 5; Rev. Rul. 60-179, 1960-1 C.B. 37.

The indebtedness must also be valid under state law. The concern here is whether the debt limit imposed by [REDACTED] of the [REDACTED] Constitution generally limiting debt to [REDACTED] percent of the assessed value of property within the political subdivision has been violated. To address this, it must first be determined whether the obligation created by the contract constitutes debt for the purposes of the constitutional limitation. In order to be constitutionally limited debt, the obligation must be present and absolute indebtedness. [REDACTED]

[REDACTED] Statutes [REDACTED] provides that bonds and notes are not includible in the computation of the constitutional debt limitation of the city. To explain this further, subsection [REDACTED] provides that the bonds or notes are payable only out of the special fund created under this law and that the bonds or notes must contain recitals to show that they are only so payable. Furthermore, the subsection states that the obligations do not constitute an indebtedness of the city or a charge against its general taxing power.

Rev. Rul. 73-481, 1973-2 C.B. 23, provides that interest derived from tax incremental districts is excludible from gross income. The revenue ruling uses a community redevelopment agency in its example rather than a municipality, but this is irrelevant to the result. Bonds are issued in the ruling; whereas, the [REDACTED] has an open account with [REDACTED]. This is also irrelevant to the result.

The tax incremental law in [REDACTED] has been held to be constitutional, and therefore the only inquiry regarding the law is whether it has been followed. [REDACTED]

[REDACTED]. The question under this law is whether entirely vacant land can constitute a tax incremental district. A careful reading of the statute relates that some vacant land may be included within a district, but the statute requires a finding during the approval process that not less than [REDACTED] percent of the real property within the district meet at least one of the following criteria: (1) is "blighted area"; (2) is in need of "rehabilitation or conservation work"; or (3) is suitable for "industrial sites" and has been zoned for industrial use. (b)(5)(AC) [REDACTED]

(b)(5)(AC)

(b)(5)(AC)

The improvement projects in the contract agreement will be undertaken by the [REDACTED]. This answers the question with regard to the sufficiency of the powers of the political subdivision.

The [REDACTED] has maintained an open account or issued installment notes in payment for the project costs. This is sufficient to constitute municipal indebtedness for the purpose of § 103. Treas. Reg. § 1.103-1(b); Rev. Rul. 60-179, 1960-1 C.B. 37.

The exercise of borrowing power is the final question of this issue. Generally, when interest is paid by a political subdivision the only issue is whether it was bargained for interest or whether the interest was mandated by statute. The latter situation occurs when a condemnation proceeding has taken place. See, United States Trust Co. of New York v. Anderson, 65 F.2d 575 (2d Cir. 1933); Holley v. United States, 124 F.2d 909 (6th Cir. 1942). No statutory condemnation has occurred here.

(b)(5)(DP)

The district director has posed two questions relating to whether the contract constituted a municipal obligation.

The first question concerns whether the contract creates an obligation for the purposes of § 103 without also creating a debt of the [REDACTED] for the purposes of the constitutional debt limit. Tax incremental financing is reasonably common within the municipal finance community, and a majority of states employ it as a device for the precise purposes that it is being used here--to make

possible development or improvement of property within a municipality and to avoid constitutional debt limitations. The key factor which avoids constitutional debt limits is the contingency for repayment of the obligations. In this instance the obligations will be repaid, if at all, from taxes resulting from the incremental increase in the assessed value of the property within the district. Thus, there is no present, absolute debt created beyond the increment collected. In [REDACTED] this avoids debt with in the constitutional limitation.

We believe any payments made were pursuant to an obligation, even though that obligation was limited to incremental receipts on the increased value of the property being improved. That is, to the extent municipal revenues increased, the [REDACTED] was obligated to pay the [REDACTED] a like amount. See, Fairbanks, Morse & Company v. Harrison, 63 F. Supp 495 (N. D. Ill. 1945), concerning a municipality that issued obligations to pay for equipment purchased for use in plants operated by the municipality. The obligations were payable only from plant revenues. The obligations were those of the municipality even though payable out of a special contingent fund rather than general revenue. Moreover, interest on those obligations was excludible by the recipient even though the source of payment was limited and contingent.

The result in this case recognizes that the definition of an obligation for the purposes of § 103 is different from an obligation for the purposes of the [REDACTED] Constitution. This is consistent with the Service's usual interpretation under § 103 prior to the Tax Reform Act of 1986. Tax-exempt financing of private activities, including redevelopment, was permitted on a broad scale prior to this revision. Now, under § 144(c) of the Internal Revenue Code of 1986 redevelopment must meet certain specific federal criteria in addition to any state requirements. If this set of facts were to occur under the 1986 Code, it is clear that the area to be developed would not meet the "blighted area" criteria since from these facts this was virgin land and not merely vacant land because previous structures had been torn down. This obligation might also be considered a private activity bond and would be subject to a state volume cap on private activity financing. 1986 Code § 146. This could have an effect on whether the activity could be undertaken.

The second question is whether the mode of transfer constitutes a condemnation award. The answer to this issue has already been suggested. Interest on condemnation awards is not an exercise of borrowing power. The theory as stated in United States Trust Co., 65 F.2d at 578 is that:

[S]tate and municipal bonds and securities issued to borrow money, tax exempt, will command a better price in the market than if they are subject to taxation, because the purchaser is

not compelled to buy them and because a free agent, may be induced by the tax exemption feature to prefer them to private bonds for investment. It disregards the whole purpose of the exemption to apply it to interest upon obligations which it can compel a citizen to take in exchange for the fair value of the property. The rate of interest is fixed by law, and neither it, nor the amount of the award adjudged as of the time of taking, is a matter which he has any control.


Actual condemnation is not required to prevent exclusion of the interest. It is sufficient if the interest is paid under the equivalent of condemnation. Such equivalence has been found in instances where condemnation was anticipated. See Spencer v. United States, 739 F. 2d 411 (9th Cir. 1984). However, where bargaining has taken place without condemnation being anticipated or threatened, the interest obligation results from the borrowing power of the municipality, rather than its condemnation power, and the interest is excludible from income. It is clear that the amount of interest exacted in this instance was negotiated between the parties. In the information before us, there is nothing to indicate that condemnation was threatened or even contemplated.

The remaining question is whether the dedication of the streets amounts to condemnation. Generally, the only difference between dedication and condemnation is that dedication is voluntary while condemnation is compulsory. 26 C.J.S. Dedication §1 (1955). For our purposes, this distinction is important. Furthermore, dedication does not transfer streets until the municipality accepts the dedication. 26 C.J.S. Dedication §34 (1955). Acceptance generally requires the dedicated property to meet certain standards. Otherwise, unsatisfactory property or property subjecting the owner to various, onerous liabilities might be thrust on a city. Condemnation usually results in the transfer of property "as is" and award of payment is made on that basis. We cannot equate dedication with condemnation. Accordingly, the property transfer was a purchase and sale with negotiated deferred payment terms.

The interest accrued by the [REDACTED] relating to the transactions in question is excludible from gross income for federal tax purposes.

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By:


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